



The Federal Report

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

The Month in Washington: March, 2008

Housing remained a hot topic from the campaign trail to the halls of Congress, with the debate over what (if anything) the government should do following traditional lines for Republicans and Democrats. After the Fed took unprecedented action to promote financial stability, Treasury Secretary Hank Paulson's regulatory reform plan seemed to lose some of its steam as most lawmakers called for more, not less, regulation. The Supreme Court cemented the law on several issues of interest to CalPERS, including the legality of health Bridge Plans for near-retirees.

Issues and Events

Lawmakers Eye Regulatory Overhaul; Philosophies May Deadlock

The Housing crisis has prompted both the Administration and Congress to examine ways to improve regulation of the financial markets responsible for delivering the current unpleasantness in the debt markets. The Fed's extraordinary efforts to save Bear Stearns continued to reverberate among policymakers and promoted discussion of changing the parts of the regulatory system that encouraged, or at least allowed, this crisis to occur.

The Fed's move to bailout Bear Stearns through the proxy of J.P. Morgan caused the more incredulous in Washington to ask why investment banks now have access to the same safety net enjoyed by commercial banks when they are subject to far less regulation in virtually every respect, including capital requirements, risk assessment, and other telling standards.

Pivotal Congressional players, including Congressman Barney Frank (D-MA) and Senator Chris Dodd (D-CT), the leaders of the committees that oversee the financial markets, now openly question the current regulatory scheme and are working on improvements. Frank recently characterized the current climate as "an investors' strike" and called for "regulation that is adequate to the scope of innovation and to the scope of activity" in the markets. Always careful not to endorse the proposal, Frank said it is time to look at a new regulator or giving the Federal Reserve broader powers to act as one. This uber-regulator would have authority over commercial banks, investment banks, Wall Street firms, hedge funds, and the recent explosion of non-bank financial companies. "To anyone who looks at the regulatory system over the last few months, it is quite clear that the

financial world has evolved dramatically and the regulatory system has not caught up,” Senator Charles Schumer (D-NY) said recently, discussing his Wall Street constituents.

Somewhat sideswiped by events, the reform proposals prepared by the Department of the Treasury and released April 1 have a new urgency. Rather than being a happy coincidence that both Administration and Congress have been working on plans in the same area, their mutual interest seems more likely to frame yet another argument over philosophy and priorities.

The Treasury group proposes eventual regulatory consolidation, a new mortgage regulator to oversee standards for brokers, new powers for the Federal Reserve to oversee all institutions in the lending business, merger of the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC), and a national charter that would void State regulation for insurers.

Congressional reaction to the plan was generally negative. “Since this is opening day in baseball, I might as well make a baseball metaphor. This is a wild pitch. It is not even close to the strike zone,” said Senate Banking Committee Chairman Chris Dodd (D-CT) in a widely cited quote. He also said of the Treasury plan that “On the one hand, it would allow the Fed to examine all financial companies — not just banks — to be sure they are not posing a risk to the overall financial system. On the other hand, it fails to realize that the Fed helped create this crisis by ignoring the red flags as far back as five years ago. It does not make sense to give a bigger shovel to the very people who helped dig us into this hole.”

Senate Majority Leader Harry Reid (D-NV) said that helping borrowers, not regulatory reform, topped his list of financially-oriented legislation. The Democrats continue to work on the details of a plan to boost the capital of Federal housing instrumentalities by \$10 billion through more bond authority. The legislation also includes a controversial provision allowing bankruptcy judges to modify the terms of first mortgages on owner-occupied properties; the Bush Administration and banking industry generally opposes this proposal.

Paulson said that the plan is not simply about more or less regulation. “The blueprint is about structure and responsibilities — not the regulations each entity would write. The benefit of the structure we outline is the accountability that stems from having one agency responsible for each regulatory objective. Few, if any, will defend our current Balkanized system as optimal,” Paulson said.

Democrats see the eagerness of firms like Bear Stearns to avail themselves of money from the Fed as a sign that investment banking needs to look more like commercial banking, at least from a regulatory standpoint. Requiring high-flying Wall Street firms to carry higher capital reserves would have protected them against the sudden collapse of some part of their assets, as happened with mortgage-backed securities. Opponents answer that more on reserve means less to lend, and less lending means less growth. New international protocols to bring the U.S. to a system more dependent on measuring risk and reserving against losses might provide the commonality between populist regulators and

free trade absolutists to strike a middle ground, tightening the current (virtually nonexistent) reserve standards for investment banks in exchange for more principles-centered rules on risk assessment.

Unless the investment banks see something in their interest, it seems unlikely that regulation can be forced upon them. Wall Street has developed and maintained powerful friends on both sides of the aisle who will have a sympathetic ear to the complaints of investment houses about new regulatory proposals and can argue that a slowing economy calls for a strong and flexible financial system. The electoral season also argues against major initiatives that shift precious turf from agency to agency.

The High Court Giveth to Employers on Retiree Healthcare ...

Without comment, the U.S. Supreme Court refused to review a decision affirming the rule by the Equal Employment Opportunity Commission (EEOC) that allows reduction in healthcare benefits when participants enter Medicare (the *Erie* decision). The underlying ruling came from the 3rd Circuit last August. The AARP had sued the EEOC over its 2003 proposed rule allowing the practice, which the EEOC viewed as not harmful to the interests of seniors and necessary to promote the goal of health coverage for any worker by allowing employers to manage costs. The rule, which now goes forward, allows coordination of employer-based benefits with Medicare under so-called Bridge Plans.

Plaintiff AARP said it was “deeply disappointed” with the ruling and said the court’s action would encourage more cutbacks of retiree healthcare. The group’s statement said the ruling “clears the way for employers to discriminate by reducing or terminating benefits for older retirees simply because they’ve turned 65 years old.” However, the legal certainty provided by the rulings assuaged employer groups, who saw the initial decision against them in *Erie* as chaining them to an escalating insurance bill and promised that, were they not allowed to reduce benefits at age 65 to account for Medicare, then many would simply end their programs entirely. The EEOC ultimately agreed with this position and offered its rule for a narrow exemption from the laws it enforces, triggering the legal action that ended last week.

... And Taketh on Lump Sum Distributions

The Supreme Court also declined to review without comment a 7th Circuit decision in *Williams v. Rohm and Haas Pension Plan* that requires cost-of-living adjustments (COLAs) for defined benefit participants receiving an annuity to be included in figuring benefits for others receiving a lump sum distribution. The underlying case affirmed the value linkage between lump-sum distributions and annuities. Both ERISA and the Internal Revenue Code mandate that lump-sums must be valued in present terms the same as a single-life annuity. The case also affirms that a COLA is a protected accrued benefit under ERISA.

The 7th Circuit opinion said in part: “When a participant in a defined benefit pension plan is given a choice between taking pension benefits as an annuity or in a lump sum, the

lump sum must be so calculated as to be the actuarial equivalent of the annuity.” Not doing so in the case of the Haas plan amounted to an illegal cut-back of benefits, regardless of whether the plan “seeks to disguise a penalty exacted against lump-sum recipients as a bonus afforded to annuitants,” in the words of the opinion. The district court granted summary judgment to Williams.

Spring Brings Blossoming of Housing Rescue Plans

Perceiving (correctly or not) political gain in proposing plans to rescue those in danger of foreclosure from the soft housing market, presidential candidates and Congressional leaders are proposing numerous plans to shore up the markets.

Senator Hillary Clinton (D-NY) continued to press the issue, including her proposal to control interest rates for the next 5 years and suspending foreclosures for 90 days. Hers is the most ambitious of any plan thus far presented, although multi-part legislation from House Financial Services Committee Chairman Barney Frank (D-MA) approaches hers. Clinton said on March 24 that “When families are losing their homes, that's also a financial crisis,” referring to Administration comments about the need to bailout stumbling Wall Street giant Bear Stearns. Most Democrats have lambasted both President Bush and presumptive GOP presidential candidate Senator John McCain (R-AZ) for a lackluster response to the crisis, with Clinton characterizing McCain's comments on March 25 about policies that “do no harm” as evocative of President Herbert Hoover. Senator Barack Obama (D-IL) gave a major address on the subject March 27, also recommending more regulation of mortgage originators and an aggressive approach to helping borrowers.

Frank's plan has some measure of broad support, with indications suggesting a good deal of agreement with not only Senators Clinton and Obama but also Frank's Senate counterpart at the Banking Committee, Chris Dodd (D-CT). An outline of Frank's philosophy on the crisis suggested several areas for attention, including: a new banking regulator, or new powers for the Federal Reserve to act as one; an approach that “regulates behavior, not form,” meaning a turn away from legal distinctions between banks and other financial institutions that extend credit, such as some insurance companies and non-bank financial companies; new rules to protect consumers, since “This crisis shows that consumer protection, safety and soundness and systemic risk are intertwined;” and consolidation of regulators. The House Financial Services Committee will hear testimony on Frank's bill on April 9, and the Chairman hopes to move the bill swiftly. Frank also has pending legislation that would extend \$10 billion to the States to address housing problems and expand the powers of the Federal Housing Authority (FHA) to restructure underwater housing loans. FHA would have about \$300 billion in spending authority via the new bonds to work in the markets.

Senator Dodd this week said that events seem to have nudged the Administration toward the more activist Congressional approach; thus far, the President has favored working housing problems out in the private sector. Dodd said of his Administration counterparts in the financial area that, “They didn't say, ‘I will support your plan.’ They did not sign

on to a plan. (But) I think they're far more supportive of this idea or something like it than they were a while ago.” On the Republican side, Senator Richard Shelby (R-AL), Ranking Member of the Senate Banking Committee, repeated his opposition to any sort of taxpayer-backed bailout of either lenders or borrowers.

Related National and Industry News

Pension Distribution Still Uneven: EBRI

Findings from the Employee Benefit Research Institute (EBRI) confirm that retirement savings remain mainly an affluent, educated, and white asset. The survey looked at DC plans, IRAs, Keogh plans, and 401(k)'s but does not include data for defined benefit plans or their participants. The study is available through the group's website.

Where the median U.S. Household income is about \$44,000 (according to 2004 Census data), households drawing \$100,000 annually control the lion's share of retirement funds at 63% of assets, and only 11% of assets were held by households making less than \$50,000. Three in four retirement asset holders had college degrees while those lacking formal higher education managed only 24.7%, split between those with some college (about 11%) or none (14.2%). The 80% of the U.S. population classified as White non-Hispanic accounted for 90.5% of retirement savings. The largest trend since 1994, according to EBRI, has been the slow but steady concentration of retirement assets in the hands of people 55 years old or older.

Public pension experts have noted for decades that uneven coverage and the perception of inequitable benefits endangers every employee and employer involved in the complex pension system, which more than a few Federal tax experts view as tremendously expensive.

AMT Offsets Continue to Encourage Legislative Creativity

While last year saw a temporary fix to this year's Alternative Minimum Tax (AMT) problem, talk of another fix has returned to the issue of providing offsets for a nearly \$70 billion change in scheduled tax receipts. Pursuing the offset would put virtually any tax change – including pensions – in play to make up the money used for AMT relief.

The AMT is a parallel tax system designed to limit and cap deductions so that the wealthy would pay some amount of tax. The original law from 1969 was unindexed, and inflation-induced bracket creep has left many more people “wealthy,” at least by the definition of the AMT.

Last year, Congress addressed the AMT problem for this year by opting not to provide offsets. Paying for changes, known as “PayGo” among Hill People, had been adopted by Democrats as a way to contrast their fiscal discipline with the Republicans who they displaced from the majority in 2006. House Democrats support the PayGo concept more

than their Senate counterparts, who saw that an offset plan would not pass muster with their Senate Republican peers. As a result, the Congress adopted the theory that the AMT was capturing income never intended to be drawn in, and therefore there was no need to offset revenues that were unintentionally coming in to the Treasury.

The argument that both the Administration and Congress counted AMT revenues normally in crafting their respective budgets ultimately did not prevail. The legislature has thus set a precedent that unintended consequences are somehow outside of the normal considerations of budgeting.

This time around, the House wants the \$70 billion AMT fix for 2009 offset to prevent the estimated \$400 billion deficit from expanding further; about 20 million essentially middle class taxpayers will be subject to AMT in that tax year. House leaders hope to package the relief bill with “fast-track” status, which cannot be filibustered by the Senate and has some chance to prevail against the opposition of Republicans and conservative Democrats. House Budget Committee Chairman John Spratt (D-SC) contrasted the House approach with that of the Bush Administration, which would also provide similar AMT relief but would not provide offsets to do so. The Senate budget plan once again concurs with that approach and election year politics complicate the political math on a proposal to raise taxes on some to prevent tax liability that many affected Americans do not even know they have.

Bush Administration reaction to the House Democrats’ plan took a familiar line. An Office of Management and Budget (OMB) spokesman said, “The administration does not believe the appropriate way to protect 22 million additional taxpayers from [the AMT] is to impose a tax increase on other taxpayers.” Conservatives point out that no-one from the majority side has proposed paying for AMT relief with spending cuts, another option for funding the tax change.

Given that this is an election year, the Senate will likely maintain its position against paying for AMT relief through tax increases or spending cuts, which are very unlikely. However, an election year also means that 20-22 million taxpayers cannot be antagonized, and the cost will likely be passed on to others through the deficit, as was done last year without much public uproar.

House Passes Mental Parity Bill

The House passed H.R. 1424, the mental health parity legislation, on March 6 by a vote of 268-148. The bill now goes to conference with S. 558, a measure passed by the Senate last year. The House bill is seen as more aggressive than the Senate version but both versions expand the Mental Health Parity Act of 1996 to promote equality in mental and physical health benefits.

The House bill, sponsored by Congressmen Patrick Kennedy (D-RI) and Jim Ramstad (R-MN), requires coverage to include all conditions in the Diagnostic and Statistical Ma-

nual of Mental Disorders. Many in industry believe that too many mental ailments are included in the manual and that coverage should focus on the more prevalent and debilitating conditions. Industry groups such as the Society for Human Resource Management (SHRM) have also expressed concern that H.R. 1424 does not create a national standard, in that States will still be permitted to enact higher standards (including standards for common mental health elements such as substance abuse), and SHRM favors a national set of rules to ease compliance and benefits administration.

The House bill also includes the language from H.R. 493, the Genetic Nondiscrimination Act, as another way to promote passage of that measure and sweeten the deal for voting to approve the main bill. The outcome of these provisions now rests with a conference with the Senate, and it seems likely that some form of this legislation will be sent to the President.

GOP Offers Employee Verification System

Congressman Sam Johnson, the top Republican of the Ways and Means Subcommittee on Social Security, introduced H.R. 5515, the New Employee Verification System, on March 6. The legislation responds to an important election issue for the right, which is generally more animated over concerns regarding illegal immigration and was the leading block that defeated a compromise measure on comprehensive immigration reform last year. Employers support the bill, according to Johnson, but it has thus far not attracted any Democratic cosponsors.

In introducing the bill, Johnson noted that it serves three main goals: ensuring a legal workforce, protecting against identity theft, and protecting Social Security. The legislation mandates use of State new hire electronic reporting (currently used for child support payment enforcement) for all new employees and requires that their identities be checked against the Social Security Administration and Department of Homeland Security databases. The new system would be completely electronic, avoiding paperwork. States could also implement a biometric identification system if they wished to do so, which would also further efforts to combat identity theft.

The proposed law would preempt any State or local law regarding this component of employment as it pertains to fines or sanctions on employers. Other provisions making the initiative more palatable to employers include applying the new requirements only to new employees and guaranteeing that employers are not responsible for the hiring practices of subcontractors.

Without support from Democrats, the bill has no chance of passage. However, it serves as a policy plank for Republicans going into the fall elections, where their voters have a high level of interest in immigration issues. Nationally, immigration is among the issues that also involves moderates, who will be pursued by both parties for the general election.

House Committee Says Veterans Unable to Get Old Jobs

The House Education and Labor Committee continues to examine issues uncovered last month at a hearing on returning veteran employment issues. The hearing offered testimony from veterans as well as emergency response personnel such as public safety officers who can encounter difficulty getting their jobs back after prolonged duty. Witnesses also told the Committee that contractors are increasingly coerced into signing mandatory arbitration agreements.

According to a release from the Committee, “reserve troops returning home from active duty in places like Iraq and Afghanistan are finding it difficult to get their jobs back, government statistics show. According to a U.S. Defense Department report, more than 33,000 reserve service members from 2001 to 2005 have complained to the agency that their employers failed to give them their jobs back – as required by law – or received a reduction in pay and benefits.”

Subcommittee on Health, Employment, Labor and Pensions Chairman Rob Andrews (D-NJ) found the arbitration procedures particularly galling. “If a worker is wronged while on the job, then that employee should have every opportunity to be made whole under the law. Unfortunately, there are too many loopholes in the law today and we have the responsibility to not allow any instance of discrimination to go unchecked.”

Legislation has not yet been introduced and is in the drafting stage.